

Service Date: February 3, 1984

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

IN THE MATTER OF THE APPLICATION OF)
PACIFIC POWER & LIGHT COMPANY FOR)UTILITY DIVISION
AN ORDER AUTHORIZING IT TO EXCHANGE)DOCKET NO. 84.1.1
INTEREST PAYMENTS WITH FINANCIAL)DEFAULT ORDER NO.5045
INSTITUTIONS.)

On January 3 , 1984, Pacific Power & Light Company (Pacific), a corporation organized and existing under and by virtue of the laws of the State of Maine and qualified to transact business in Montana, filed with the Montana Public Service Commission its verified application, pursuant to Sections 69-3-501 through 69-3-507, MCA, requesting an order (1) disclaiming jurisdiction over transactions designed to reduce Pacific's exposure to fluctuations in interest rates or (2) authorizing Pacific to enter into contractual arrangements pursuant to which it would exchange payments with a financial institution to fix substantially the cost of its tax-exempt borrowings effected and to be effected in Docket Nos. 81.11.104 and 83.6.48 or (3) authorizing the proposed transactions to the extent jurisdiction exists. Whether jurisdiction is asserted or disclaimed, Pacific requests conceptual approval of the transaction costs for inclusion in rates.

The application is supported by exhibits and data in accordance with the rules and regulations of the Commission governing the authorization of the issuance of securities by electric and gas companies operating within Montana.

For detailed information with respect to the general character of Pacific's business and the territories served by it, reference is made to its annual reports on file with the Commission.

The application sets forth Counsel who will pass upon the legality of the proposed issuance, the other regulatory authorizations required, and the propriety of the proposed transactions.

At a regular open session of the Montana Public Service Commission, held in its offices at 1227 Eleventh Avenue, Helena, Montana, on January 16, 1984, there came before the Commission for final action the matters and things in Docket No. 84.1.1 , and the Commission, having fully considered the application and all data and records pertaining to it on file with the Commission and being fully advised in the premises, makes the following:

FINDINGS

1. Pacific is a corporation organized and existing under and by virtue of the laws of the State of Maine and is qualified to transact business in the State of Montana.
2. Pacific is operating as a public utility as defined in Section 69-3-101, MCA, and is engaged in furnishing electric and water service in Montana.
3. The Commission has jurisdiction over Pacific's Montana utility operations under Section 69-3-102, MCA.

4. Notice of the application was published as a part of the Commission's regular weekly agenda.

5. In recent years, Pacific has found that the least costly source of permanent financing available to it (albeit for special purpose assets) has been and is expected to be the proceeds of Floating Rate Monthly Demand Pollution Control Revenue Bonds (Bonds) issued by Sweetwater County, Wyoming and the City of Forsyth, Montana, the interest on which Bonds is exempt from income taxation. The interest rate on the Bonds is significantly less than the interest rate on fixed rate pollution control bonds. Yet, using the floating rate Bonds allows Pacific to achieve only the first of its two goals for permanent financing -- (a) long-term funds and (b) fixed cost funds.

6. Although it can borrow much less expensively utilizing the Bonds, Pacific believes that prudent utility financing practice calls for minimizing the financing of long-term assets at floating rates. Therefore, Pacific wishes to reduce its exposure to short-term rate volatility by entering into arrangements to fix effectively its exposure to some of its floating rate obligations.

7. The most effective way currently to protect against volatility, in Pacific view, is the so-called interest rate swap or interest payment exchange. The names are really misnomers; in an interest rate swap, obligations are not exchanged. Rather, each of the parties enters into a contractual arrangement to make or receive payments that, in effect, converts its lowest cost borrowing alternative into its preferred borrowing method.

8. Pacific proposes initially to exchange the interest payments on \$50,000,000 in aggregate principal amount of the Bonds with a bank, finance company, or other financial institution (Bank). However, because the floating interest rate is and

will be the same for all of the Bonds, the proposed transactions will be equally applicable to any of the Bonds up to a \$50,000,000 principal amount.

9. An exchange (or swap) of interest payments is a relatively recent development in the financial markets. Typically, two parties borrow identical amounts of money under terms most favorable to each of them -- one at a fixed interest rate and the other at a floating or adjustable interest rate. The transaction is designed to reduce the borrowing costs of both parties by their agreeing to make payments to each other that effectively convert floating rate obligations to fixed rate obligations and convert fixed rate obligations to floating rate obligations. Neither party gives up its underlying obligation to make payments on its own borrowings as a result of the transactions because the payments are made pursuant to an agreement separate from the interest payments on the respective borrowings of the parties.

10. The incentive for entering into an interest payment exchange arises as follows:

- a. Desiring to borrow at a fixed rate, a utility finds it can borrow upon more favorable terms at a floating or an adjustable interest rate.
- b. Desiring to borrow at a floating or adjustable rate, a Bank finds it can borrow at relatively more favorable terms at a fixed interest rate.

11. The difference (or spread) between the costs of identical fixed rate borrowings by the utility and the Bank exceeds the difference between the costs of identical floating or adjustable rate borrowings by the utility and the Bank. An exchange is designed to take advantage of this spread differential.

12. The interest payment exchange takes advantage of a structural discontinuity in the debt markets. As borrowers with lower credit ratings pay a greater risk premium in the fixed interest rate debt market, borrowing by the lesser credit rated entity in the variable interest rate market and entering into a swap with another entity to fix its interest rates results in a lower cost borrowing even when the additional transactions and intermediary costs are considered.

13. Parties to an exchange need not even deal with each other, but may arrange the exchange through a third party intermediary or agent.

14. The result of the transactions proposed is that Pacific would be able to achieve its second goal of permanent financing but at a cost significantly reduced from the cost it would incur by arranging a fixed rate financing of pollution control revenue bonds. Both Pacific and the Bank would achieve a lower cost financing than available to it convention ally for the form of borrowing it prefers.¹

15. Pacific expects to classify the payments made as “other interest expense” and the payments received as “other income”.

16. Pacific intends to seek rate recognition of any interest payment exchanges arranged. As the purpose of the transactions proposed is to fix substantially the amount of

¹ Banks prefer to borrow at floating rates to match fund with their typically floating rate loan portfolios thereby earning a constant spread between the two rates (floating rate loan asset paired with a floating rate obligation). Utilities prefer to borrow at fixed rates to lock in the money cost of an asset for the relatively long life of the assets that they typically finance (fixed rate asset paired with a fixed rate obligation). Banks reduce their exposure to interest rate changes by obtaining the variable interest rates while utilities reduce their exposure to interest rate changes by obtaining fixed interest rates.

interest rate expense over the life of the exchanges, Pacific intends to seek recovery through rates of the effective cost of the borrowings after the exchanges are in place rather than the interest expense on the Bonds underlying the exchanges.

17. In a sense, the exchange agreements proposed are similar to an insurance policy. The fixed rate actually paid may be temporarily in excess of the underlying floating rate expense but it protects against potentially higher liabilities in the future because it is expected to fix substantially the rate in the 7 to 8 percent per annum range as compared to the 20 percent per annum maximum interest rate on the Bonds. The exchange would insure that neither Pacific nor its customers would have to pay the maximum interest rate on the Bonds during the term of the exchange agreement.

18. The proposed exchange agreements could also be likened to a debt issue refunding. While interest rates are low, a floating rate debt issue with no interest rate cap or without a cap at a sufficiently low level is refunded by the issue of a fixed rate debt issue with a rate slightly higher than that on the existing floating rate issue but lower than the expected average interest rate over the life of the floating rate issue to be refunded.

19. The interest payment exchange alternative has an additional advantage over refunding alternatives which may be as compelling as the cost savings. If adverse federal legislation is passed at any time over the next seven to ten years, Pacific could well be precluded from refunding the outstanding Bonds with another new tax-exempt issue at the end of that seven or ten year period. The interest payment exchange, while initially structured for a seven to ten year period, retains the 30-year maturity of the existing Bonds (2011 and 2013). At the termination of the exchange agreement, Pacific

could either enter into another exchange or return to the underlying tax-exempt, floating rate.

20. Pacific is unwilling to assume the risk that the prudent costs of the exchange transactions may not be included in rates. Yet Pacific realizes that the Commission cannot surrender its authority to judge the prudence of the transactions proposed. Accordingly, Pacific seeks only approval in concept that the transactions costs may be recovered through rates as an allowable expense if executed prudently.

21. Without this conceptual approval for inclusion in rates, Pacific will not undertake the proposed transactions.

22. For its first interest payment exchange based on \$50,000,000 of the Bonds, Pacific expects to pay the following:

Private placement fee of	\$250,000
Intermediary fee annually of	62,500
Additional fees of	87,500

23. Benefits resulting from the transactions proposed are expected to be:

- a. Lower long-term cost of financing.
- b. Reduced earnings volatility.
- c. Restored capacity to undertake a limited amount of floating rate obligations.
- d. Avoidance of issuing fixed rate refunding securities with additional covenants.

24. The transactions proposed are part of an overall plan to minimize the cost of Pacific's financings which support its on-going construction program and its in-service plant.

25. There are to be no proceeds from the transactions, only a change in the effective cost of each series of the Bonds used as a base for the interest exchange payments. No securities will issue and no obligations (as in a loan agreement or guarantee) will be undertaken. Only contractual arrangements to make payments to and receive payments from financial institutions will result.

CONCLUS IONS

Because no securities are to issue and no proceeds are to be obtained, the transactions proposed are extra jurisdictional. Accordingly, Pacific's request for a disclaimer of jurisdiction is reasonable and should be approved.

Because the transactions proposed are not contrary to the public interest, conceptual approval for including the transaction costs in rates should be approved.

ORDER

IT IS THEREFORE ORDERED that:

1. The application of Pacific Power & Light Company, filed on January 3 , 1984, for a disclaimer of jurisdiction over the proposed transactions is approved.

2. The further request of Pacific Power & Light Company for conceptual approval for including in rates the costs of the transactions proposed is approved. Specific approval as to the prudence of execution of the transactions proposed is withheld by the Commission until the appropriate rate proceeding.

3. Issuance of this order does not constitute acceptance of Pacific Power & Light Company's exhibits or other material accompanying the application for any purpose other than the issuance of this order.

4. Approval of the transaction authorized shall not be construed as precedent to prejudice any future action of this Commission.

5. Nothing contained herein shall be construed to obligate the State of Montana.

6. This order shall be effective upon execution.

DONE IN OPEN SESSION at Helena, Montana, this 16 day of January,
1984, by a 5 to 0 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION.

THOMAS J. SCHNEIDER, Chairman

JOHN B. DRISCOLL, Commissioner

HOWARD L. ELLIS, Commissioner

CLYDE JARVIS, Commissioner

DANNY OBERG, Commissioner

ATTEST:

Madeline L. Cottrill Secretary

(SEAL)

NOTICE: Any interested party may request the Commission to reconsider this decision.

A motion to reconsider must be filed within ten (10) days. See 38.2.4806, ARM.